

Essential Utilities, Inc.

WTRG: Solid Update Provided at 1/11 Guidance Event

WTRG Remains Our Favorite Water Utility Pick

Overweight/\$52

Water Utilities

Earnings Estimates Revised Up

• **Key Points.** We viewed WTRG's 1/11 guidance event as supportive of our Overweight thesis. The '21 EPS guidance range of \$1.64-1.69 was consistent with investor expectations and management extended the 5-7% EPS CAGR through '23. New items include (1) two new municipal transactions totaling \$87M as well as (2) red meat for ESG conscience investors. We nudge up our 2021-24E EPS to/from \$1.67/\$1.65, \$1.80/\$1.78, \$1.93/\$1.91 & \$2.07/\$2.03. We also introduce our 25E of \$2.20. Our forecast results in an EPS CAGR near the upper end of WTRG's targeted 5-7% range which we believe is reasonable given strong underlying rate base growth driven by accelerated pipeline replacement needs supplemented by a municipal M&A strategy that continues to gain momentum.

• **2 New M&A Deals Revealed – Positive Momentum Continues.**

WTRG closed four municipal deals in 2020 for total rate base of \$63M. In the pending column, the \$277M DELCORA deal steals the show however WTRG has four other transactions with a combined value of \$144M – includes three separate chunky wastewater deals (East Whiteland, PA \$55M; Lower Makefield, PA \$53M; Bourbonnais, IL \$32M). WTRG has also been announced the winning bidder of two additional systems with a combined value of \$30M which will move into the pending column once APA's are finalized. The company's deal development pipeline remains robust and management continues to express optimism that activity will start ramping up in the years ahead in the four states that only somewhat recently adopted FMV legislation (NC & OH in '18; TX in '19; VA in '20). Our model reflects primarily announced deal closures over the 2020-22 period plus a \$75M/year placeholder in '23 & beyond.

• **Spotlighting DELCORA (Again!).** As we have previously opined, we believe the DELCORA deal represents material long-term value that is not currently reflected in the share price. Following the favorable court rulings on 12/28, PaPUC approval is the remaining hurdle with next key milestones including a 1/20 anticipated ALJ recommendation and a 3/11 commission approval deadline. Beyond the \$277M rate base pick up at closure (expected early Q2'21), we are attracted to (1) the \$700M of capital investments – \$25-50M/year for typical repair/replace work plus roughly \$300M over the 2026-28 period related to DELCORA's treatment plant – as well as (2) the likely substantial wastewater tuck-in deals that could transpire in the area. Simply put, we believe the DELCORA deal should, at a minimum, allow WTRG to continue to target a 5-7% EPS CAGR through the end of the decade if not bump it up to 6-8%.

• We offer some additional highlights from the 1/11 update on p.2 including (1) extension of the rate base growth targets, a brief discussion of the relatively low near-term regulatory risk profile and (3) announcements to hopefully lessen the ESG overhang.

\$	2019A	2020E	2021E
EPS		Curr. Prior	Curr. Prior
Q1 (Mar.)	0.28	0.60 A	NC 0.67 NE
Q2 (June)	0.37	0.29 A	NC 0.25 NE
Q3 (Sep.)	0.48	0.23 A	NC 0.25 NE
Q4 (Dec.)	0.34	0.46	NC 0.50 NE
FY	1.47	1.58	NC 1.67 1.65
CY	1.47	1.58	1.67
FY P/EPS	32.6x	30.4x	28.7x
Rev.(MM)	890	1,931	2,055

Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters
 NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful
 V = Volatile
 Adjusted EPS excludes items considered non-recurring.
 WTRG expects 2021 adjusted EPS of \$1.64-1.69 range and targets a 5-7% EPS CAGR through 2023 off the 2019 adjusted base of \$1.47.
 WTRG expects 2020 adjusted EPS at the top end of the \$1.53-1.58 range.

Ticker	WTRG
Price Target/Prior:	\$52/NC
Price (01/11/2021)	\$47.98
52-Week Range:	\$30-55
Shares Outstanding: (MM)	245.2
Market Cap.: (MM)	\$11,764.7
S&P 500:	3,799.61
Avg. Daily Vol.:	931,178
Dividend/Yield:	\$1.00/2.1%
LT Debt: (MM)	\$5,277.4
LT Debt/Total Cap.:	53.2%
ROE:	9.0%
3-5 Yr. Est. Growth Rate:	7.0%
CY 2021 Est. P/EPS-to-Growth:	4.1x
Last Reporting Date:	11/03/2020
	After Close

NC = No Change

Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters

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Please see page 4 for rating definitions, important disclosures and required analyst certifications. All estimates/forecasts are as of 01/11/21 unless otherwise stated. 01/11/21 17:29:09 ET

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Other highlights from the 1/11 guidance event and update include:

- **Capex & Rate Base Guidance Largely Upheld.** Management indicated plans to invest \$550M on the water/wastewater side (ex. M&A) in '21 and \$450M for gas (up from \$400M in '20). In total, roughly \$3B of spend is expected over the 2021-23 period which will drive underlying 6-7% water/wastewater and 8-10% gas rate base CAGRs through '23. More than 50% of the spend is eligible for rider mechanism recovery
- **WTRG offers investors relatively low near-term regulatory risk.** The next PA water & wastewater rate case filing is expected in late '21. While WTRG's PA rate cases can never be overlooked given the meaningful % of rate base represented (more than 70% on the water/wastewater side), the utility has a long history of reaching constructive outcomes via settlement agreements and the ALJ recommendation in the pending AWK case honors a settlement agreement reached on 10/30.

Otherwise commission approvals for FMV deals as well as regulatory treatment of the catchup portion of Peoples' repairs tax deduction (RTD) are the main items we are keeping an eye on at the state level. Further on the RTD treatment, a PaPUC order is expected in Q2'20 and we are optimistic that something similar to WTRG's proposal will be adopted. We would not rule out the possibility of a settlement with intervenors and note that evidentiary hearings are scheduled for later this month. Recall, WTRG's proposal would share the benefits 40% with ratepayers (through rate surcredits on bills) with the remaining 60% used as an increasing income tax expense offset over 2023-25 – this would avoid the need for Peoples to file to implement a base rate increase prior to 1/1/2026 while supporting the elevated pace of capex deployment and ensuring a fair opportunity to earn the allowed ROE.

- **Addressing The ESG Overhang.** WTRG committed to reducing annual Scope 1 and 2 GHG emissions by 60% by 2035 (using 2019 baseline) across both the gas and water utility platforms utilizing existing and proven methods and will look to get to net zero once technological advances allow. Other ESG-friendly updates include establishing multi-year plans to increase supplier and employee diversity as well as tying incentive comp to those metrics. Successfully addressing the ESG concerns that arose out of the recent acquisition of the Peoples gas utility and gaining wider spread acceptance by the investment mantra that seems to only be growing in popularity could help close some of the valuation gap between AWK.

Acronyms:

ALJ – Administrative Law Judge
 APA – Asset Purchase Agreement
 DELCORA – Delaware County Regional Water Quality Control Authority
 ESG – Environmental, Social, Governance
 FMV – Fair Market Value
 GHG – Greenhouse Gas
 PaPUC – Pennsylvania Public Utility Commission

Price Target

Price Target: \$52 from NC

Our \$52/share price target reflects both a P/E multiple and DDM analysis. In terms of P/E, we apply a 70% water/30% gas utility hybrid multiple to our 2022E of \$1.80. For WTRG's water utility multiple, we ascribe a roughly 5% discount to the 21E multiple we use for AWK (34-34.5X, which is a 5-10% premium to the pure play water peer group median). We consider AWK to be WTRG's closest peer on the water side based on scale, key states/regions and municipal consolidation strategies. The roughly 5% discount reflects a modestly lower earnings growth rate (we forecast 6-7% for WTRG's water business vs. 8% for AWK) as well as lower ESG appeal (primarily due to the Peoples gas utility). For WTRG's gas utility multiple, we utilize the 21E pure play gas LDC median of 17.0-17.5X (based on ATO, NWN, OGS & SR) and then apply a roughly 10% premium to it. We believe a premium is warranted as (1) Peoples is at the early stages of a multi-year accelerated pipeline replacement effort which is expected to drive healthy rate base growth for the foreseeable future (WTRG's 3-year guidance is 8-10%), (2) we believe Western PA, which sits above the prolific Marcellus and Utica shale plays, is largely immune to the anti-gas sentiment impacting some areas of the country and (3) most of Peoples falls under the constructive PA regulatory framework. Key risks relate to regulatory, Peoples gas deal integration and M&A strategy execution.

Investment Thesis

Our Overweight rating is premised on our belief that WTRG shares do not fully reflect the company's strong fundamentals which include a proven EPS growth strategy, a rate base that is growing at a mid-to-upper single digit CAGR, constructive regulatory treatment (particularly in PA where roughly 70% of earnings are derived and near-term regulatory risk is low as both the water and gas utilities completed rate cases in 2019), an efficient operating model and a solid financial profile. We believe relatively low risk, regulated EPS growth of at least 6% is achievable driven by the timely rate recognition of elevated pipeline infrastructure investment needs for the foreseeable future supplemented by water/wastewater municipal M&A trends.

Company Description

Headquartered in Bryn Mawr, PA, Essential Utilities (WTRG) - formerly Aqua America - is one of the largest U.S.-based investor-owned regulated water and wastewater utilities. The company serves approximately 3 million residents (1 million customer connections) in Pennsylvania, Ohio, North Carolina, Illinois, Texas, New Jersey, Indiana and Virginia. WTRG's largest subsidiary, Aqua Pennsylvania, accounts for approximately half of the company's total water customer base and nearly 70% of consolidated water rate base. Going forward, the company has expressed a desire to accelerate customer growth through a more active and focused acquisition strategy across its entire portfolio.

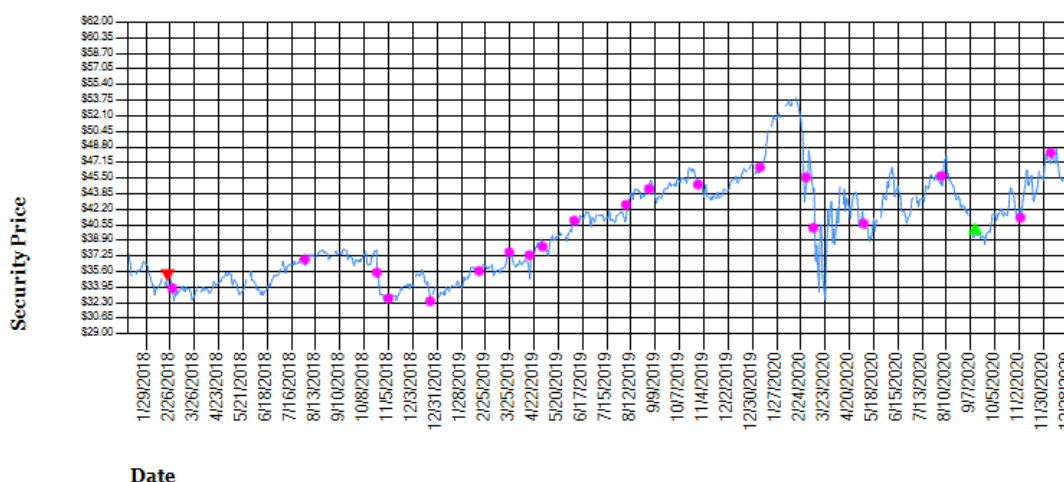
In March 2020, WTRG closed on the acquisition of Peoples - a predominately Pennsylvania-based gas utility serving 740k customers - from SteelRiver Infrastructure Partners for an enterprise value of \$4.275B (includes \$1.3B of assumed debt). From a price perspective, WTRG paid 1.9-2.0X rate base, 14.8X EV/EBITDA and nearly 25X P/E - lofty multiples but not that dissimilar to other gas utility transactions at the time. Management expects the deal to be EPS accretive in the first full year after close (2020) but stressed this is a strategic-driven, not synergy-driven, transaction.

Regulated operations account for more than 99% of consolidated revenues. Consolidated EPS is expected to be driven roughly 70% by water utility operations with the gas utility contributing the remaining 30%.

In February 2020, the new name Essential Utilities, Inc. and new ticker WTRG became effective. Prior, the company was known as Aqua America Inc. and traded under the ticker WTR.

Required Disclosures

Essential Utilities, Inc. (WTRG) 3-yr. Price Performance



Date	Published Price (\$)	Rating Code*	Price Target	Val. Rng. Low	Val. Rng. High	Close Price (\$)
1/8/2018		Reeder				
1/8/2018	NA	1	43	NE	NE	37.71
▼ 2/25/2018	35.00	2	37	NE	NE	35.00
◆ 3/1/2018	34.19	2	36	NE	NE	33.66
◆ 8/2/2018	36.70	2	38	NE	NE	36.70
◆ 10/24/2018	35.01	2	37	NE	NE	35.29
◆ 11/6/2018	32.70	2	35	NE	NE	32.59
◆ 12/24/2018	33.87	2	34	NE	NE	32.38
◆ 2/19/2019	35.54	2	36	NE	NE	35.52
◆ 3/26/2019	37.52	2	39	NE	NE	37.52
◆ 4/18/2019	36.52	2	38	NE	NE	37.15
◆ 5/3/2019	37.85	2	39	NE	NE	38.09
◆ 6/9/2019	40.84	2	42	NE	NE	40.84
◆ 8/8/2019	42.06	2	44	NE	NE	42.47
◆ 9/2/2019	44.29	2	47	NE	NE	44.29
◆ 10/29/2019	44.90	2	46	NE	NE	44.68
◆ 1/8/2020	46.51	2	48	NE	NE	46.51
◆ 3/2/2020	43.01	2	45	NE	NE	45.44
◆ 3/11/2020	44.41	2	48	NE	NE	40.03
◆ 5/7/2020	40.49	2	42	NE	NE	40.53
◆ 8/6/2020	45.56	2	45	NE	NE	45.56
▲ 9/14/2020	39.35	1	45	NE	NE	39.82
◆ 11/4/2020	41.19	1	47	NE	NE	41.19
◆ 12/10/2020	47.70	1	52	NE	NE	48.02

*Effective December 7, 2019, Wells Fargo Securities' Equity Research modified its ratings definitions. Complete definitions of current ratings can be found below. For information related to prior ratings definitions, please contact equityresearch1@wellsfargo.com.

Source: Wells Fargo Securities, LLC estimates and Reuters data

Symbol Key

▼ Rating Downgrade

▲ Rating Upgrade

◆ Price Target/Val Range Change

◆ Initiation, Resumption, Drop or Suspend

■ Analyst Change

□ Split Adjustment

Rating Code Key

1 Overweight/Buy SR Suspended

2 Equal Weight/Hold NR Not Rated

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WTRG: Key risks relate to regulatory, Peoples gas deal integration and M&A strategy execution.

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As of: January 11, 2021

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